Loon Energy Inc.

[1998 Annual Report]

Corporate Profile

Loon Energy Inc. is a publicly traded energy company engaged in exploring for, developing and producing crude oil and natural gas in Western Canada. The Company owns interests in producing properties at Grand Forks and Carvel, Alberta as well as reserves and undeveloped mineral rights in Central and Southern Alberta and Western Saskatchewan. Loon commenced activity as an oil and gas company in August 1997. The common shares of Loon were listed for trading on the Alberta Stock Exchange (symbol: LEY) in March 1998. At year end 1998, there were 9,481,124 common share-equivalents outstanding.

The annual and special general meeting of Loon Energy Inc. will be held at 3:00 p.m. on June 3, 1999 in the Barber Room at The 400 Club, 710-4th Avenue S.W. Calgary, Alberta.

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Abbreviations

°API	Gravity or density of liquid petroleum products defined by the American Petroleum Institute
ARTC	Alberta Royalty Tax Credit
bbl	Barrel (34.972 Imperial gallons or 42 U.S. gallons)
MSTB	Thousand stock tank barrels
Mcf	Thousand cubic feet
MMcf	Million cubic feet
Bcf	Billion cubic feet
Boe	Barrels of oil equivalent
NGL's	Natural gas liquids

President's Message

1998 represented Loon's first full year of operations. Loon reached several significant milestones during the year which have prepared the Company for its next stage of growth.

Specifically, 1998 was a year in which the Company:

- **Purchased an interest in a producing property, providing the Company's first operating income as a base for growth.**
- **Participated in a significant Swan Hills gas discovery at Strachan, Alberta which is expected to commence production in late second quarter, 1999.**
- **Identified low-risk drilling in the Lower Mannville at Strachan from logs run on the discovery well, with drilling planned for mid-1999.**
- **Developed several other prospects to be drilled later in 1999 and acquired land and seismic on these prospects.**
- **Commenced operations on the drilling of its first operated well at Carvel, Alberta.**
- **Farmed out an oil prospect, resulting in a cased well at Dina, Alberta.**
- **Implemented accounting and other internal systems.**
- **Received approval for the relisting; its common shares commenced trading March 17, 1998.**
- **Completed two private placement financings.**

Subsequent to year-end, Loon drilled its first operated well, a gas discovery at Carvel, Alberta. It was tied in and commenced production in April 1999 and will provide a substantial increase in production and operating income. In addition to production from the Carvel discovery, Loon has three projects expected to increase cash flow in the next few months: tie-in of the Strachan discovery, drilling of the Strachan twin well and drilling of the Warwick gas prospect. The aggregate increase will position Loon to improve its balance sheet and pursue other prospects later in the year.

While property acquisitions will continue to form part of Loon's strategy, Loon's current cash position dictates the allocation of capital to the tie-in of existing reserves and drilling of our two low-risk prospects. Current acquisition price levels in the industry remain high and do not meet Loon's economic criteria. In the early part of 1998, Loon was particularly active evaluating properties; a large number of offers were submitted, and in all but one (Grand Forks), the Company was outbid. Loon's primary focus has been on developing internally generated prospects. To that end, land has been leased and seismic shot and acquired on some new prospects with a view to drilling in 1999 and beyond. In 1998, Loon increased its land ownership to a healthy 16,600 gross acres, or 3,008 net acres, three-quarters of which is undeveloped. Loon currently has Crown and freehold leases with drilling potential in Carvel, Willingdon, Birch, Epping, Silverdale and Strachan. Loon has also exercised its option to drill a well to earn an interest on a lease at Warwick.

President's Message

The Grand Forks property continues to provide solid cash flow. Average production of 53 bbls/d oil was Loon's sole source of cash flow in 1998. The Company's netbacks remained favourable in 1998, despite the sharp decline in oil prices, although development drilling was deferred.

Loon's original plans to participate in 4 to 7 exploration wells in 1998 were not realized as a consequence of reduced cash flow caused by lower oil prices and unforeseen operational delays in its Carvel and Strachan projects. Nonetheless, Loon's business strategy, as outlined below, is unchanged:

Loon Energy's Corporate Strategy

- **Increase cash flow by exploration, development and acquisition of oil and gas properties.**
- **Focus on areas with shallow- to medium-depth, multi-zone potential, existing infrastructure and year-round access: Central/Southern Alberta, Western Saskatchewan.**
- **Acquire properties which can be exploited through further drilling and recompletion projects and through production optimization. Target companies which are motivated to sell properties; avoid third party deals.**
- **Negotiate seismic options at little or no up-front cost to the company.**
- **Negotiate farm-ins on reasonable terms.**
- **Acquire Crown and freehold land where costs are reasonable.**
- **Maintain an appropriate "risk-reward" balance.**
- **Limit exposure on future projects to $100,000/well in the short term.**
- **Maintain an appropriate balance between gas, light oil and heavy oil.**
- **Operate properties where possible and practical.**
- **Minimize administration and maintain focus.**

President's Message

Financial

Loon realized net operating income of $121,217 in 1998, compared to nil for 1997. Oil production averaged 53 bbls/d for the period from April 1, 1998, when Loon's first production began. At year-end, Loon's production base was 100% weighted to oil, although virtually all new upcoming production additions will be natural gas and associated liquids. The average oil price received was $13.81/bbl. Operating costs and royalties (net of ARTC and processing income) were $5.47/bbl, resulting in a netback of $8.34/bbl. This netback decreased slightly through the year due to falling oil prices and natural production declines. Loon's revolving credit line stood at $180,000 drawn out of the $360,000 available as of December 31, 1998.

In the third quarter, Loon received regulatory approval for a prospectus which cleared for trading the common shares issuable upon exercise of Class A and B special warrants issued in December 1997. Accordingly, the Company issued 3,944,750 common shares in October. In December 1998, Loon completed a private placement financing, raising a total of $150,000 by issuing 1,000,000 flow-through common shares. In January 1999, Loon received regulatory approval to clear for trading substantially all of the common shares issuable upon exercise of Class C and D special warrants issued in June 1998. Conversion of the Class C and D special warrants will result in a further 1,093,500 shares being issued. Loon now has 9,481,124 common share-equivalents issued and outstanding.

Corporate

Cash flow additions from Carvel and Strachan will have a major impact on the Company's operating income, cash flow and production levels. Loon expects to have a solid balance sheet by year-end 1999 and to be able to invest in additional internally generated plays and acquisitions.

The Company continues to prudently manage its general and administrative (G&A) expenses. With current reductions in G&A combined with its projects coming on-stream, Loon expects to be able to yield a healthy level of monthly cash flow by year-end 1999, allowing for increased levels of activity.

The three private placement financings in 1998 resulted in a total cash influx of $743,125. These funds were utilized to finance development at Carvel and Strachan as well as seismic and land acquisitions on Loon prospects.

Participation agreements with TUSK Energy Inc., the largest shareholder of Loon, provided Loon with an initial business plan as part of the requirements for re-listing the common shares on the Alberta Stock Exchange. These agreements have now expired and neither company has any further related

obligation to the other. Through these agreements, Loon participated in the drilling of one well in 1997 at Windfall and two wells in 1998 at Strachan and Pine Creek. TUSK participated in the drilling of one well in 1999 at Carvel. The Windfall and Pine Creek wells were dry and abandoned. Strachan is a completed gas well, expected to commence production in the near future and Carvel commenced production in April 1999.

In early 1998, the Company welcomed Ken Heuchert, P. Eng. to the board of directors following the resignation of Jim Lawson, C.A. The Company wishes to thank Mr. Lawson for all of his efforts during Loon's startup phase. Effective May 1, 1998, Tom Field, P. Eng., previously Vice President, Production, was appointed President, Chief Operating Officer and Director. Effective June 25, 1998, Jeff Boissonneault, the Company's Vice President, Exploration, was appointed Director.

On April 1, 1999, Tom Field was appointed Chief Executive Officer of the Company in addition to his duties as President and Director.

Outlook

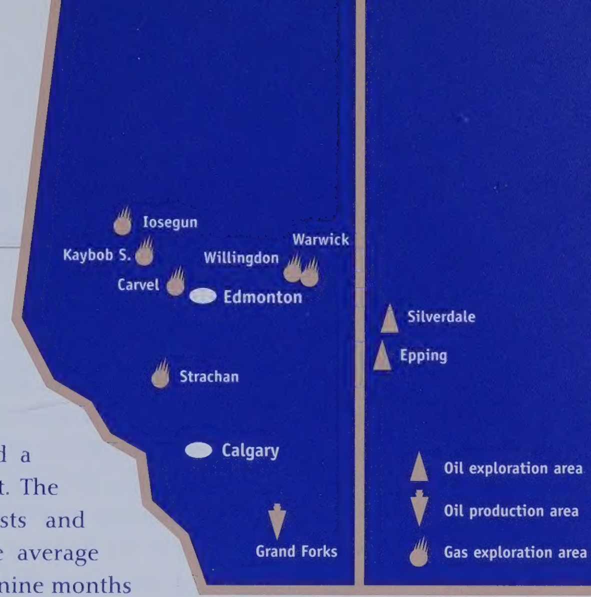
Loon's Carvel, Strachan and Warwick projects are expected to yield substantial increases in operating income for Loon in 1999. It is expected that the Company's production and reserves will be heavily weighted to gas by year-end. Loon has maintained an inventory of high-quality drilling prospects, which it will pursue through either direct participation or farmout for a carried interest. These internally generated prospects will continue to form the basis for Loon's activities and allow Loon the flexibility to allocate its capital appropriately. Loon has a solid business strategy and maintains flexibility so that adjustments may be made in response to available opportunities and changing industry conditions. The management team expects to attain a critical mass in 1999 to justify further growth.

Yours Truly,

T.H. Field

Thomas H. Field, P. Eng.
President and Chief Executive Officer
April 16, 1999

Areas of Activity



Grand Forks

Loon acquired the Grand Forks property effective April 1, 1998, and it was Loon's sole producing property in 1998. Despite low oil prices, this non-operated property generated a good netback due to low operating costs and ARTC treatment. The average oil price was $13.81/bbl, combined operating costs and royalties were $5.47/bbl and the netback was $8.34/bbl. The average production rate was 53 bbls/d of medium-gravity crude in the nine months from the effective date. Loon holds an average 21.5% working interest in the property, which is located approximately 70 kilometres southwest of Medicine Hat. Current production at Grand Forks is from ten producing Glauconitic oil wells, primarily on 40-acre spacing. Loon has identified potential development drilling locations on both existing and reduced spacing approvals that will be pursued once oil prices recover sufficiently.

Strachan

The Strachan earning well, ACL et al Strachan 2-22-38-9W5 (Loon 10% before payout, 5% after), was drilled in 1998 and resulted in a significant Swan Hills gas discovery. Four sections of land were earned with the drilling of the well and Loon now holds an average 5.5% working interest in 12.5 sections, or 8,000 acres, in the area. The Swan Hills zone in the well was completed and tested in June, July and August, yielding a final flow rate of 4.8 MMcfd at a high flowing pressure. The well is now to be tied-in to the Gulf Midstream Strachan gas plant, approximately 4 miles to the south. A number of other potential hydrocarbon-bearing zones were encountered and evaluated by open hole logs. Due to hole condition while drilling, the operator was unable to drillstem-test these "uphole" zones, and a twin well is required to access these reserves. Currently, plans are in place to drill this low-risk twin well (Loon 5%) in the second quarter of 1999. Strachan is an area that will provide immediate cash flow for Loon while offering tremendous potential from a large land base.

Carvel

In February 1999, Loon drilled its first operated gas well at Carvel, located 35 kilometres west of Edmonton. The well, Loon Carvel 3-33-53-2W5, was a major dual-zone gas discovery for Loon. On completion, the well flowed gas at an aggregate rate of 4.7 MMcfd from the two zones at high flowing pressures with associated recoverable NGL's of 16 bbls/MMcf. The well was tied in to a gas plant one-quarter mile away, firm pipeline transportation secured and a gas sales contract signed in March 1999. Loon has a 16.67% working interest in the 3-33 well and one additional section of land nearby. An industry partner paid 100% of Loon's net costs through to casing point. Production began April 11, 1999 at a restricted initial raw gas rate of 1.6 MMcfd (270 Mcfd net) while the well was flow tested "in-line," or directly to the plant. It is expected that, following the test, the initial sales gas rate will be 2.4 MMcfd (net 400 Mcfd, with associated NGL's of 7 bbls/d). Only one of the two zones will be produced initially due to plant limitations.

Areas of Activity

Warwick/Willingdon

Under a seismic option with an industry partner, Loon shot and evaluated seismic at Warwick in mid-1998 and subsequently exercised a drilling option. A well planned for mid-1999 will target Nisku (D-2) gas with secondary potential in the Camrose, Basal Quartz and Viking formations. Drilling depth is less than 800 metres and Loon's interest is 50%. Loon also has a 50% interest in a one section (640 acre) lease at Willingdon, purchased at a January 1998 Alberta Crown land sale. Gas potential exists in the Nisku and Camrose Dolomite with reserves potential of one to three Bcf and productivity of one to two MMcfd. A well at Willingdon is planned for late 1999 or early 2000. At Birch, 15 miles southeast of Warwick, Loon purchased a 20% interest in a one section lease at a September 1998 land sale. Existing seismic data has been identified and will be acquired to evaluate drilling potential. With the drilling of its first well in mid-1999, Loon hopes to beginning developing the Warwick/Willingdon lands and create a new core area for the Company. The Company has had discussions with other companies that have a presence in the area, with the intention of initiating a joint venture or farmin arrangement. Low cost drilling, multi-zone potential and existing infrastructure allow for acceptable risk and attractive economics for Loon.

Dina

Loon obtained a seismic option on one section of land at Dina, in East Central Alberta, in January 1998. Following a seismic program undertaken by Loon shortly thereafter, an oil prospect was identified. Due to the Company's prioritization of gas projects, it was decided to farm out the Dina prospect. An industry partner drilled and cased a well at 7-24-44-1W4 in December and will complete the well, all at no cost to Loon. Log interpretation indicates low productivity oil, and the operator has deferred completion of the well until after spring breakup to minimize costs. Loon has a 50% working interest at Dina, as well as a 50% interest in two additional sections at Dina North which it earned by shooting the Dina seismic.

Epping, Silverdale

Development on the Company's lands at Epping and Silverdale, just south of Lloydminster, has been deferred pending improvement in heavy oil prices. These lands, acquired at a December 1997 Saskatchewan Crown land sale, will provide low-risk development drilling when economic conditions warrant. The potential on these lands is estimated at 175 BOPD net to the Company's 50% interest.

Kaybob South, Iosegun

Loon has the option to participate for a 20% working interest in a well on each prospect to earn a 20% working interest before payout and 10% after payout. Kaybob is a Devonian Blueridge gas prospect with the potential for 3.0 Bcf plus 100 bbls/MMcf NGL's, while Iosegun is a Triassic oil prospect with potential for 680 MSTB. Both are in "winter-only" areas and would not be drilled until 2000. Loon's participation would be weighed against other projects at that time.

Management's Report on Responsibility

The consolidated financial statements are the responsibility of the management of Loon Energy Inc. They have been prepared in accordance with generally accepted accounting principles, using management's best estimates and judgements, where appropriate.

Management is responsible for the reliability of the consolidated financial statements, the notes to the consolidated financial statements, and other financial information contained in this report. In the preparation of these statements, estimates are sometimes necessary because a precise determination of certain assets and liabilities is dependent on future events. Management believes such estimates have been based on careful judgements and have been properly reflected in the accompanying financial statements.

Management is also responsible for maintaining a system of internal controls designed to provide reasonable assurance that assets are safeguarded and that accounting systems provide timely, accurate and reliable information.

The board of directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The board is assisted in exercising its responsibilities through the audit committee of the board, which includes three non-management directors. The audit committee meets periodically with management and the auditors to satisfy approval of the financial statements to the board.

Ramsay, Dalton & Co., the independent auditors appointed by the shareholders, have audited the Company's consolidated financial statements in accordance with generally accepted auditing standards and their report follows. The independent auditors have full and unrestricted access to the audit committee to discuss their audit and their related findings as to the integrity of the financial reporting process.

T.H. Field

Thomas H. Field, P. Eng.
President and Chief Executive Officer

Jeffrey M. Boissonneault, P. Geol.
Vice-President, Exploration

Auditors' Report to Shareholders

To the Shareholders of Loon Energy Inc.:

We have audited the consolidated balance sheets of Loon Energy Inc. as at December 31, 1998 and 1997 and the consolidated statements of operations and deficit and cash flow for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and the disclosures in the Financial Statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and 1997 and the results of its operations and the changes in its cash flow for the years then ended in accordance with generally accepted accounting principles.

Ramsay, Dalton & Co.

Ramsay, Dalton & Co.,
Chartered Accountants, March 10, 1999, Calgary, Alberta

Loon Energy Inc.
Consolidated Balance Sheets

As at December 31	1998	1997
Assets		
Current Assets		
Cash	$ 5,615	$ 590,090
Accounts Receivable (Note9)	42,049	7,258
Prepaids and Deposits	9,437	16,188
	57,101	613,536
Capital Assets (Note 3)	1,316,097	125,359
	1,373,198	738,895
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts Payable (Note 9)	$ 349,484	$ 60,016
Current Portion of Long Term Debt	60,000	–
	409,484	60,016
Future Site Restoration	6,600	–
Long Term Debt (Note 4)	420,000	–
Debenture (Note 5)	75,000	75,000
Shareholders' Equity (Note 6)		
Share capital	$ 825,906	1,825,905
Deficit	(363,792)	(1,222,026)
	462,114	603,879
	$ 1,373,198	$ 738,895

See Accompanying Notes

APPROVED BY THE BOARD

Norman W. Holton
Director

Robert R. Hobbs
Director

Loon Energy Inc.
Consolidated Statements of Operations

For the years ended December 31	1998	1997
Oil Revenues, Net	$ 197,372	$ –
Expenses		
Operating Costs	75,150	–
Depletion and Depreciation	279,000	60,000
Provision for Future Site Restoration	6,600	–
General and Administrative	158,163	50,796
Debenture and Interest	42,251	10,478
	561,164	121,274
(Loss) from Operations	(363,792)	(121,274)
Gain on Settlement of Debts	$ –	$ 46,555
(Loss)	(363,792)	(74,719)
(Loss) Income per Share	$ (0.05)	$ (0.02)

Consolidated Statements of Deficit

As at December 31	1998	1997
Deficit, Beginning of Period	$ (1,222,026)	$ (1,147,307)
Reduction of Stated Capital (Note 6)	1,222,026	–
Net (loss) Income	(363,792)	(74,719)
Deficit, End of Period	$ (363,792)	$ (1,222,026)

See Accompanying Notes

Loon Energy Inc.
Consolidated Statements of Cash Flow

For the years ended December 31	1998	1997
Operations		
(Loss)	$ (363,792)	$ (74,719)
Add Items not Affecting Cash		
Provision for Future Site Restoration	6,600	–
Depletion and Depreciation	279,000	60,000
	(78,192)	(14,719)
Change in Non-Cash Working Capital	261,428	(128,195)
	183,236	(142,914)
Financing		
Long Term Debt	$ 480,000	–
Advances from (to) Shareholders and Directors	–	(26,750)
Issue of Share Capital in Settlement of Debt	–	152,397
Issue of Share Capital for Cash	743,125	977,900
Share Issue Expenses	(34,098)	(122,742)
	1,189,027	980,805
Investing		
Capital Assets	$ (1,956,738)	$ (248,358)
	(1,956,738)	(248,358)
Increase (Decrease) in Cash	(584,475)	589,533
Cash, Beginning of Period	590,090	557
Cash, End of Period	$ 5,615	$ 590,090

See Accompanying Notes

1. Future Operations

The Company began operations as an oil and gas company in August, 1997. Recovery of oil and gas property costs capitalized to date and the payment of creditors is dependent on the Company's ability to generate future profitable operations and raising additional equity funding (see note 9).

2. Significant Accounting Policies

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles and include the following significant accounting policies.

a) Principles of Consolidation

The financial statements consolidate the accounts of the Company and its wholly owned subsidiaries, Trident Creative Technology Inc. and Zama Energy Ltd.

b) Business Combination with Trident Creative Technology Inc.

Effective August 1, 1993, Titan Diversified Ventures Ltd. ("Titan") entered into a share purchase agreement with Trident Creative Technology Inc. ("Creative") and the Creative shareholders to acquire all outstanding common shares of Creative for consideration of 10,000,000 shares in Titan. As the former shareholders of Creative held majority ownership of the outstanding shares of the Corporation following this issuance of shares, the business combination was accounted for as a reverse takeover. Subsequent to the reverse takeover transaction, the name of the combined entity was changed to Trident Systems Inc. Effective August 18, 1997, the common shares of the Company were consolidated on a four for one basis. In conjunction with the consolidation, the name of the Company was changed to Loon Energy Inc. and the Company commenced operations as an oil and gas company.

c) Oil and Gas Properties

The Company follows the full cost method of accounting in accordance with the guidelines issued by the Canadian Institute of Chartered Accountants, whereby all costs associated with the exploration for and development of oil and gas reserves are capitalized. All such costs are accumulated in one cost centre representing the Company's activities undertaken in Canada. Such costs include land acquisitions, drilling and geological and geophysical expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and gas properties unless crediting the proceeds against accumulated costs would result in a significant change in the rate of depletion.

Costs capitalized in the cost centers are depleted using the unit-of-production method, based on estimated proven oil and gas reserves, before royalties, as determined by independent consulting engineers. For purposes of the depletion calculation, oil and gas reserves are converted to a common unit of measure on the basis of their relative heating value. The carrying value of undeveloped properties is excluded in the depletion calculation.

In applying the full cost method, the Company performs a ceiling test which limits the capitalized costs less accumulated depletion and depreciation to an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on year-end prices and costs, and after deducting estimated future general and administrative expenses, future abandonment and site restoration costs, financing costs and income taxes.

The Company periodically reviews the costs associated with undeveloped properties to determine whether the costs will be recoverable. An impairment allowance is made if the results of the review indicate an impairment has occurred.

Estimated future site restoration costs are provided for using the unit-of-production method based upon estimated proven reserves. Costs are estimated by the Company based upon current regulations, costs, technology and industry standards. Removal and site restoration expenditures will be charged to the accumulated provisions as incurred.

d) Joint Ventures

Substantially all of the Company's oil and gas activities are conducted jointly with others. The accounts reflect only the Company's proportionate interest in such activities.

e) Flow-Through Shares

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. Petroleum and natural gas properties and share capital are reduced by the estimated cost of the renounced tax deductions when the expenditures are incurred.

f) Measurement Uncertainty

The amounts recorded for depletion and depreciation of capital assets and the provision for future abandonment and site restoration costs are based on estimates. The ceiling test is based on such factors as estimated proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of future periods could be material.

g) Deferred Income Taxes

The Company follows the deferral method of tax allocation accounting under which the provision for corporate income taxes is based on the earnings reported in the accounts and takes into account the tax effects of timing differences between financial statement income and taxable income, except as explained in Note 7.

h) Per Share Amounts

Per share amounts have been calculated using the weighted average number of common shares outstanding during the year.

i) Comparative Figures

Certain comparative figures have been reclassified to conform with the current financial statement basis of presentation.

3. Basis of Presentation

Capital Assets December 31, 1998	Cost	Accumulated Depletion, Depreciation	Net Book
Oil and gas properties	$ 1,643,740	$ 336,000	$ 1,307,740
Office equipment	11,356	3,000	8,356
Rental equipment	1	–	1
	$ 1,655,097	$ 339,000	$ 1,316,097

Capital Assets December 31, 1997	Cost	Accumulated Depletion Depreciation	Value
Oil and gas properties	$ 176,492	$ 60,000	$ 116,492
Office equipment	8,866	–	8,866
Rental equipment	1	–	1
	$ 185,359	$ 60,000	$ 125,359

During the year administrative overhead expenditures of $154,000 (1997 - $44,485) directly related to the acquisition, exploration and development of petroleum and natural gas reserves have been capitalized. No interest has been capitalized to oil and gas properties in either of the years ended December 31, 1998 or 1997. The depletion calculation has excluded unproved properties of $113,000 (1997 – nil).

As a result of a ceiling test calculation performed with an effective date of December 31, 1998 it was determined that the future net revenues from proved reserves approximated the net book value of the Company's petroleum and natural gas properties calculated under the full cost accounting guideline. The prices used in the ceiling test calculation were the year end prices for the Company of $11.61 per barrel of crude oil and $2.50 per mcf of natural gas. The ceiling test is a cost recovery test and is not intended to result in an estimate of the fair market value. A writedown of $180,000 was made and included in depletion expense for expenditures made prior to the purchase of producing properties effective April 1, 1998.

As at December 31, 1998 the estimated future site restoration costs to be accrued over the remaining proved reserves are $31,000 (1997 – nil).

4. Long Term Debt

Bank Loan	$ 180,000
Promissory Note	300,000
Balance, August 31, 1998	480,000
Less: Current portion	(60,000)
	$ 420,000

a) Pursuant to a financing arrangement with a Canadian financial institution, the Company has a $360,000 revolving reducing demand loan secured by a $2.5 million fixed and floating charge debenture and a general assignment of principal operating agreements, production receivables and contracts associated with the properties of the Company. The available loan reduces by $20,000 per month beginning December 31, 1998.

b) The Promissory Note payable bears interest at the bank's Prime Rate plus 1% and is subordinated to the bank loan and debenture. The holder TUSK Energy Inc. ("TUSK"), a shareholder of the Company, has agreed not to demand repayment before January 1, 2000.

5. Debenture

Subsequent to February 15, 1994 the Company was served with notice by the holder of a $100,000 debenture demanding payment . On September 14, 1994, certain shareholders of the company advanced $75,000 to the Company which sum was used to pay down the original debenture. The balance of $25,000 owing on the original debenture was paid out in common shares of the Company.

The Company issued debentures in the amount of $75,000 to those shareholders who had put up the funds for the settlement of the original debenture. The debenture is convertible at the option of the holder into 750,000 common shares.

New debentures bear interest at a rate of 12% per annum after February 10, 1995 and are secured by a general security agreement covering all assets of the Company. The debenture holders have agreed to not demand repayment before January 1, 2000.

6. Share Capital

a) Authorized Share Capital

Unlimited Number of Common Shares

Unlimited Number of Preferred Shares

b) Common Shares Issued

	# Shares	$
Balance December 31, 1996	15,977,584	$ 881,350
Cancellation of Escrow (see below)	(8,302,000)	–
	7,675,584	881,350
Share Consolidation (see below)	1,918,896	–
Issued for Settlement of Debt	1,523,978	152,397
Balance December 31, 1997	3,442,874	1,033,747
Conversion of Class A Special Warrants	2,000,000	105,700
Conversion of Class B Special Warrants	1,944,750	296,572
Issuance of Flow-Through Common Shares	1,000,000	150,000
	8,387,624	1,586,019

	# Warrants	$
Private Placement Class A		
Flow-Though Special Warrants	2,000,000	$ 200,000
Less		
Issue Expenses	–	(5,300)
Tax Effect of Flow-Through Special Warrants	–	(63,000)
Balance December 31, 1997	2,000,000	131,700
Less		
Tax Effects of Flow-Through Special Warrants	–	(26,000)
Conversion of Special Warrants	(2,000,000)	(105,700)
Balance December 31, 1998	–	–

	# Warrants	$
Private Placement Class B		
Flow-Through Special Warrants	1,944,750	$ 777,900
Less		
Issue Expenses	–	(117,442)
Balance December 31, 1997	1,944,750	660,458
Less		
Issue Expenses	–	(16,886)
Tax Effect of Flow Through Special Warrants	–	(347,000)
Conversion of Special Warrants	(1,944,750)	(296,572)
Balance December 31, 1998	–	–

	# Warrants		$
Private Placement Class C			
Flow-Through Special Warrants	927,500	$	510,125
Less			
Issue Expenses	–		(17,212)
Tax Effect of Flow-Through Special Warrants	–		(114,000)
Balance December 31, 1997	927,500		378,913
Private Placement Class D			
Flow-Through Special Warrants	166,000		83,000
Reduction of State Capital	–		(1,222,026)
Total Share Capital			
December 31, 1998		$	825,906

The common shares of the Company were consolidated on the basis of four shares of Trident Systems Inc. for one share of Loon Energy Inc. effective August 18, 1997.

c) Escrow Agreement

Pursuant to an Escrow Agreement effective March 2, 1998 among the Corporation, Montreal Trust Company of Canada, TUSK Energy Inc. and Norman W. Holton, 345,155 Common Shares owned by TUSK Energy Inc. and 573,084 Common Shares owned by Mr. Holton are subject to escrow. All such shares will be automatically released from escrow, on an equal basis on each of the first, second and third anniversaries of the date of such agreement. In addition, a total of 1,650,000 Common Shares issuable to insiders of the Corporation on exercise of 1,650,000 Class A Special Warrants will have a legend imposed on such shares which will allow 550,000 Common Shares to be traded on the expiration of six, twelve and eighteen months from March 17, 1998.

8,302,000 of the Company's issued and outstanding pre-consolidation shares, subject to escrow, were cancelled effective August 21, 1997.

d) Stock Options

A total of 740,000 options to purchase common shares of the Corporation are outstanding. All of the options were issued effective as of September 23, 1997 and are exercisable at any time prior to September 23, 2002. Of the total, 340,000 options have an exercise price of $0.10 and 400,000 options have an exercise price of $0.40. Of the options exercisable at a price of $0.10 per share, one-third will vest equally on a semi-annual basis over a period of 18 months from March 17, 1998.

e) Special Warrants

One common share will be issued, at no additional cost to the holders of Class C and Class D Special warrants, upon exercise of each Class C and Class D Special Warrant. 83,000 Series 2 Warrants were issued to holders of the Class D Special Warrants. Two Series 2 Warrants were issued to holders of the Class D Special Warrants. Two Series 2 Warrants together with $0.60 will entitle the holder to purchase an additional common share until April 30, 1999. Proceeds recorded in share capital will be reduced by the estimated cost of the renounced tax deductions of $217,000 when the expenditures are incurred (seeNote 9(b)).

f) Broker Warrants

194,475 broker warrants were issued by the Corporation to the agent as partial consideration for fees payable in connection with the issuance of Class B Special Warrants. Each broker warrant is exercisable into an equal number of agent's warrants. Each agent's warrant entitled the holder to purchase one common share at a price of $0.40 until December 19, 1998. An aggregate 16,750 Broker Warrants were issued by the Corporation to Goepel McDermid Inc. and Odlum Brown Limited, as agents, as partial consideration for fees payable in connection with the issuance on June 9, 1998 of the Class C Special Warrants and the Class D Special Warrants. Each Broker Warrant is exercisable into an equal number of agents warrants. Each agent's warrant entitles the holder to purchase one Common Share at a price of $0.55 (as to 15,750 agents warrants) and $0.50 (as to 1,000 agents warrants).

g) Share Purchase Warrants

As discussed in Note 4 the debenture is convertible at the option of the holder into 750,000 common shares. As well, the holders of the original debenture retained 187,500 share purchase warrants which allows them to acquire 187,500 shares at a minimum price of $0.10 a share within two years of the Company's Shares being listed for trading.

h) Reduction of Share Capital

At the annual shareholders meeting held June 25, 1998, the shareholders of the Company adopted a special resolution to reduce the stated capital of the Common Shares by $1,222,026 and, as a result, the deficit of the Company was reduced by the same amount.

7. Income Taxes

The company and its subsidiaries have non-capital losses of approximately $759,000 which could be used for the reduction of future years' taxable incomes and have been carried forward for income tax purposes. These non-capital losses expire as follows.

1999 –	$73,000
2000 –	$378,000
2001 –	$61,000
2002 –	$99,000
2003 –	$11,000
2004 –	$65,000
2005 –	$72,000

In addition, the Company has net undeducted tax pools of approximately $2,165,000 that could be deducted from future taxable income.

At December 31, 1998, share capital and oil and gas properties have been reduced by $550,000 as the estimated cost of renounced income tax deductions.

No recognition has been made in the accounts for possible reduction of income taxes in future years resulting from these tax losses and tax pools.

8. Uncertainty Due to the Year 2000 Issue

The year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on or after January 1, 2000 and if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Company's ability to conduct normal business operations. It is not possible to be certain that all aspects of the year 2000 issue affecting the Company, including those related to the efforts of customers, suppliers or third parties, will be fully resolved.

9. Commitments

a) Effective August 1, 1997 TUSK agreed to supply certain personnel and general, accounting and administrative services to the Corporation for a monthly fee of $4,000. The agreement expired December 31, 1997 and was extended to January 1999. One officer of the Company is also an officer of TUSK, one director of the Company is also a director of TUSK and one director of the Company is an officer of TUSK.

Pursuant to letter agreements the Company may farm-in on certain prospects of TUSK, based on the same terms as other partners. TUSK and the Company have also entered into reciprocal exploration and participation agreements with each other whereby each of TUSK and the Company will have the right, but not the obligation, to participate in each other's prospects. Included in accounts receivable is $27,199 owing from TUSK at December 31, 1998 and included in accounts payable is $154,585 owning to TUSK at December 31, 1998.

b) At December 31, 1998 the Company had a commitment to incur and renounce a further $408,000 of tax attributes associated with exploratory and development activities.

Corporate Information

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TUSK Energy Inc.

Jeffrey M. Boissonneault, P. Geol.
Vice-President, Exploration
Loon Energy Inc.

Ian T. Brown, P. Geol.
Vice-President, Exploration
Gadsby Energy Ltd.

Thomas H. Field, P. Eng.
President and Chief Executive Officer
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Kenneth R. Heuchert, P. Eng.
Manager, Capital Sales
U.S. Filter / Petwa Ltd.

Robert R. Hobbs, C.M.A.
President
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Norman W. Holton, P. Geol.
President and Chief Executive Officer
TUSK Energy Inc.

OFFICERS

Jeffrey M. Boissonneault, P. Geol.
Vice-President, Exploration

Thomas H. Field, P. Eng.
President and Chief Executive Officer

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Chairman

Brian W. Mainwaring
Secretary

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STOCK EXCHANGE LISTING

Alberta Stock Exchange
Symbol: **LEY**

WHOLLY OWNED SUBSIDIARIES

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Zama Energy Ltd.

AUDITORS

Ramsay, Dalton & Co.
Calgary, Alberta

BANKERS

National Bank of Canada
Calgary, Alberta

SOLICITORS

Code Hunter Wittmann
Calgary, Alberta

REGISTRAR AND TRANSFER AGENT

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Loon

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